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The chief reason for the financial confusion in the late 1920s, as in similar eras of the past, was the credit inflation. Combined with stable price levels, it generated a sense of security and an overestimation of the expansionary potential. This misled a dynamic society into reckless speculative ventures on an unprecedented scale. Believers in monetary stability were carried away by their wishful thinking.

— Melchior Palyi, *The Twilight of Gold: 1914–1936, Myths and Realities,* 1972

THE TRUE GREENSPAN LEGACY

Let us start with the second sentence of the Federal Open Market Committee's press release to the recent rate hike on Nov. 1, 2005, because it explains in a few words the extraordinary optimism the Greenspan team has about the U.S. economy:

> *Elevated energy prices and hurricane-related disruptions in economic activity have temporarily depressed output and employment. However, monetary policy accommodation coupled with robust underlying growth in productivity, is providing ongoing support to economic activity that will likely be augmented by planned rebuilding in the hurricane-affected areas.*

During the three months ending October 2005, consumer spending in the United States fell at an annual rate of about 7%.

Apparently, the Fed sees just two problems in the U.S. economy: higher energy prices and temporary hurricane damage, which will quickly turn upward due to the rebuilding of the affected area. Forget about structural problems like negative savings, the monstrous trade deficit, record-high debts, unusually slow employment and income growth, wage growth below the inflation rate, protracted weakness in business fixed investment, etc.

Assessing the U.S. economy's performance, we distinguish between long-term structural problems and short-term cyclical performance. The Fed sees enormous short-term strength; we see short-term weakness. Stating this, our eyes are on the monthly changes in consumer expenditures, in contrast to the grossly inflated annualized quarterly changes.

Looking at the monthly figures, consumer outlays have already shown pronounced weakness since March 2005. But this has been concealed by successful auto promotions in June–July, followed by new, steeper declines, lasting more than three months now.

The big issue looming large in the background is, of course, the growth-impairing variety of structural imbalances in the U.S. economy. Instead of addressing them, the ultra-sized monetary and fiscal stimulus of the past several years has dramatically worsened them. The result has been the most anemic economic growth with the most misaligned pattern.

Blessed with total ignorance in macroeconomics, American policymakers and economists are unable to see anything but hurricane effects.

PAUL VOLCKER FOREWARNED

Reading so many ecstatic laudations on Fed Chairman Alan Greenspan, "the greatest of all central bankers,"

two other names and occurrences came to mind. The one was John Law and his tremendous wealth creation through rigorously inflating the share prices of the Mississippi Company. And the other was former Fed chief Paul Volcker and his recent article in the *Washington Post* titled *"An Economy On Thin Ice,"* wherein he expressed his desperation about the economic and financial development in the United States. Though he never mentioned his successor's name, it was all about him and his policies.

Just a few samples from Paul Volcker's assessment:

> *Under the placid surface, there are disturbing trends: huge imbalances, disequilibria, risks — call them what you will. Altogether, the circumstances seem to me as dangerous and intractable as any I can remember, and I can remember quite a lot. What really concerns me is that there seems to be so little willingness or capacity to do much about it…*
>
> *I don't know whether change will come with a bang or a whimper, whether sooner or later. But as things stand, it is more likely than not that it will be financial crises rather than policy foresight that will force the change.*

UNAFRAID TO DEPART FROM THE RULE

What, after all, are the great merits of Mr. Greenspan, according to the conventional laudations? They are, actually, seen in two different fields: *first*, in the striking successes of his actual policies; and *second*, in notable contributions to both the theory and practice of monetary policy.

His policy successes seem, indeed, all too conspicuous: lower inflation rates than expected despite strong GDP growth; high gains in job growth; and low rates of unemployment. And yet only two mild recessions, of which the second one, in 2001, was so mild that it disappears when quarterly data are aggregated to a year.

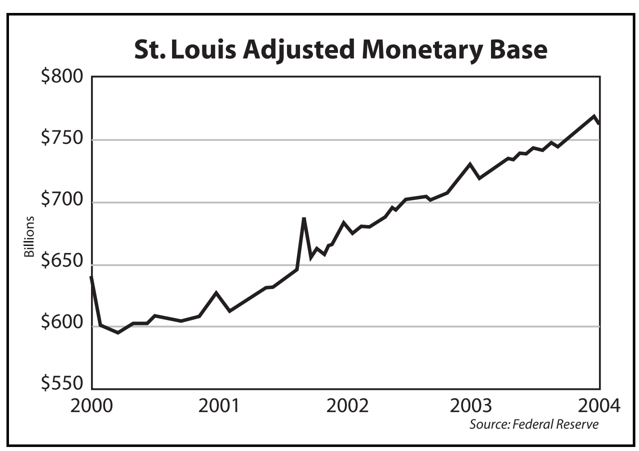
His extraordinary successes are generally attributed to radically new practices in monetary policy. The *Financial Times* ran a full-page article under the big headline *"Greenspan's Record: An Activist Unafraid to Depart From the Rule."*

To quote the paper presented by Alan S. Blinder and Ricardo Reis of Princeton University at the Federal Reserve Bank of Kansas City symposium on this point: *"Federal Reserve policy under his chairmanship has been characterized by the exercise of pure, period-by-period discretion, with minimal strategic constraints of any kind, maximal tactical flexibility at all times and not much in the way of explanations."*

It is true Maestro Greenspan disregarded any established rules in central banking. To escape the consequences of the equity bubble that he created in the late 1990s, he generated a whole variety of new bubbles that radically changed the U.S. economy's growth pattern. What he achieved was the greatest inflation in asset prices in history, which became the economy's new engine of growth. What about its inevitable aftermath?

MORE MONETARY EASE

If Alan Greenspan jettisoned all inherited rules, he nevertheless chose one predominant rule, actually, his only rule: a strictly asymmetric policy pattern. Every central bank has two policy levers at its disposal. The big lever is changing bank reserves, the banking system's liquidity base. The little lever consists in altering its short-term interest rate.



Whenever monetary easing appeared opportune, Mr. Greenspan has acted rigorously with both levers. When it seemed to require some tightening, he always acted hesitantly and only with his little interest lever. He has never seriously tightened bank reserves. Though

hard to believe, he has actually been easing the Fed's reserve stance since last May.

This is most probably occurring because the continuous rampant credit expansion is increasing the banking system's reserve requirements. Nevertheless, to keep the federal funds rate at its targeted level of 4%, the Fed has to provide the higher reserves.

What this means should be clear: The Fed is anxious to avoid any true monetary tightening in the apparent hope that the "measured" rate hikes will softly do the job over time, causing less pain. Most probably, though, this implies more rate hikes and more pain — later.

It was, as a matter of fact, precisely the same kind of experience that induced Volcker to abandon such strict funds rate targeting in October 1979 in favor of targeting bank reserves. It marked the fundamental divide in U.S. monetary policy from prior persistent monetary looseness and a strong inflation bias to genuine credit tightening, ushering in a secular decline in the inflation rates.

The Greenspan Fed has returned to dubious interest targeting, while explicitly restricting itself to "measured" — in other words, very slow — rate hikes. The true monetary ease shows in the continuance of the relentless credit deluge.

When Alan Greenspan took over as Fed chairman in 1987, outstanding U.S. debts totaled $10.57 trillion. According to the latest available data, they stand at $37.35 trillion. This is definitely Mr. Greenspan's most conspicuous achievement.

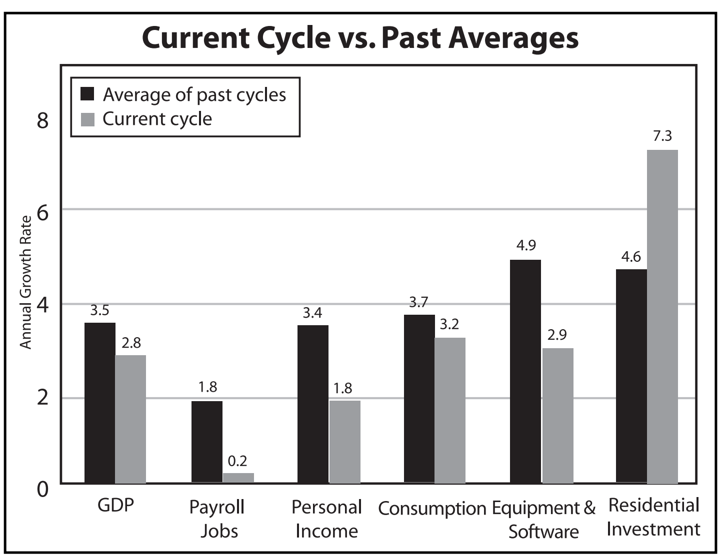
YET THE WEAKEST POSTWAR RECOVERY

Back to the Greenspan legacy. While his reign has lasted a long 18 years, the last four to five years since the bursting of the equity bubble are those of greatest importance for himself and the U.S. economy's future. These years reveal the Greenspan fiasco.

There is no question that he is the person with the greatest responsibility for the excesses of the U.S. equity bubble in the late 1990s. Not only did he stoke it with unprecedented monetary looseness, but he also acted as its most prominent cheerleader with exuberant laudations on a "new paradigm" economy, reasonably justifying new highs in stock prices.

Over the whole postwar period, recoveries from a prior recession have always been the "golden" phases of economic development, when economies delivered their best in virtually every single economic respect: employment, investment, incomes, profits, etc.

The U.S. economy's recovery from its low in November 2001 is the first great exception to this golden rule. By virtually any measure, it has grossly lagged all past postwar recoveries. This fiasco has been hidden from the American public by diverting attention to the slower growth in Europe and Japan. The appropriate question to ask is how well has the economy performed compared to past recoveries in the United States?



Let us first take a look at the facts, as illustrated in the chart to the left.

The fact is that by any measure, except one, the U.S. economy's current recovery grossly lags past recoveries. The one and only exception is residential construction.

Further, a proper comparison has to take into account substantial changes in the

measurement of three aggregates: inflation rates, the unemployment rate and reported job growth. Plainly, these three aggregates are of particular political expediency.

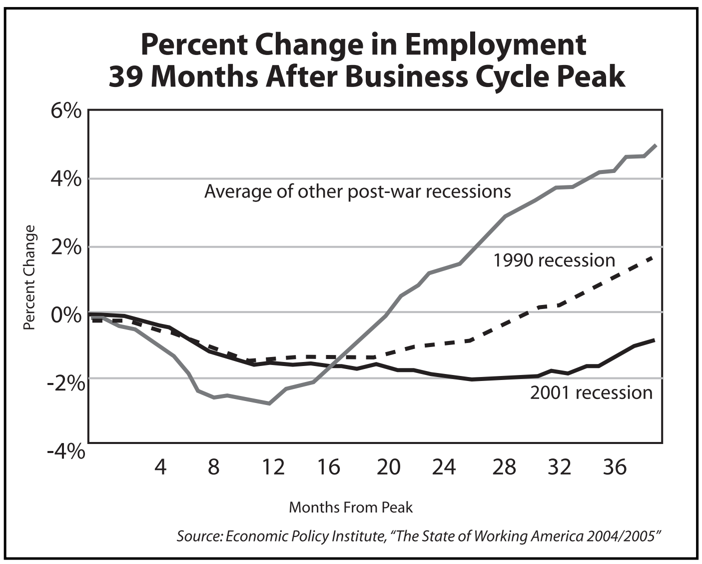
Think of the substantial understatement of consumer price inflation through hedonic pricing and the ridiculously low housing costs through the "owners' equivalent rent of primary residence." Think of the statistical disappearance of more than 5 million unemployed persons through the gimmick of "discouraged workers." And also think of the almost 900,000 new jobs that the dubious "net birth/death model" cranks out every year.

Drawing this comparison, also please keep in mind that the present recovery has been treated with gigantic fiscal and monetary stimulus. The Economic Policy Institute in Washington estimates the various tax cuts during 2001–03 at $860 billion, equivalent to about 7% of GDP. Moreover, the Greenspan Fed reinforced this unprecedented fiscal boost with monetary easing of equally unprecedented vigor.

Yet with all this fiscal and monetary help, the economy's recovery from the recession of 2001 has been its weakest recovery by far in the whole postwar period, far weaker than the prior slowest recovery from the 1991 recession, at the time generally labeled as a jobless recovery.

THE JOBS MACHINE THAT FAILED

By far, the weakest component in the current economic recovery has plainly been job and labor income growth. Overall employment is just 1.3% above its level in March 2001, the start of the recession. Private sector jobs are up only 0.8%, versus an average increase by 8.6% in all prior recoveries from recession. That is just one-tenth of the average job growth in prior postwar recoveries.



The chart on the left reveals an employment disaster in this recovery. It took 46 months after the recession until the labor market had regained lost jobs. It took 31 months to achieve this in the infamous "jobless" recovery during the first half of the 1990s. The average for all other recoveries was 21 months.

Weighing these shocking numbers, it has to be considered that the dubious net birth/death ratio contributed more than 2 million new jobs over the past few years. In their absence, private sector employment would be substantially lower today than it was in 2001.

The general, comforting explanation is to ascribe this employment disaster to the economy's productivity miracle, which lasted even through this period of much slower growth. It is a miracle, for sure, but a statistical one, not an economic one. As a rule, strong productivity growth goes together with strong business investment, which creates jobs. Given very weak business investment in the United States, the stellar productivity numbers are more than suspect.

There is one thing that strongly supports this suspicion. Wage growth tends to reflect productivity growth. Employers' wage costs have grown just 2.3% over the past year. This was their lowest growth rate on record. Factoring in the higher inflation rate, hourly wage rates have dropped 2.3% in real terms over the past year. This is the highest loss of purchasing power for wages on record for this series since 1981.

Because other sources of income have been rising faster than wages and salaries, total personal income (including rent, interest, dividends, proprietors' income and transfer payments) has increased substantially faster.

Here too, though, it needs a strong reservation about the numbers. This refers to a big component in the official income figures titled *Imputations in the National Income and Product Accounts*, by the Bureau of Economic Analysis. These are fictive incomes created by the BEA simply through a stroke of the pen with the argument that people receive benefits for which they do not pay, and which it therefore adds to GDP and income growth.

In 2004, such imputations totaled $1,746.5 billion within overall GDP of $11,734.3 billion. In the case of disposable personal income, they amounted to $924.1 billion of overall $8,664.2 billion. The single biggest item is an imaginary rent on owner-occupied housing. These “imputed” incomes keep rising regardless of the weaknesses in other income data.

AN UNUSUAL GROWTH PATTERN

In any case, the disastrous employment performance raises the question, what are the underlying causes? Looking for an explanation, the obvious thing to see is that it coincided with an unprecedented, anomalous pattern of economic growth.

The unusual growth pattern began with the unusual pattern of the prior recession. In past recessions that were typically due to monetary tightening in response to rising inflation rates, all credit-financed demand components — consumer durables, business and residential investment — declined sharply.

During the 2001 recession, given the Fed’s steep interest rate cuts, all three components behaved very differently. Consumer spending on durables and residential investment never paused and accelerated, while business fixed investment suffered its steepest fall in the postwar period.

Ever since then, the U.S. economy’s decisive cause of weakness is clearly centered in business fixed investment. Not responding at all to the Fed’s first quick rate cuts, it has inched up since early 2003, only reaching its former level of 2000 in the fourth quarter of 2004, while spending on residential building and consumer durables are up 35% for each. Business fixed investment continues to grow, but far too slowly for a self-sustaining recovery.

The single biggest depressant of the U.S. economy over these years has been the soaring trade deficit, virtually doubling from $400 billion to $800 billion at annual rate. By diverting domestic spending to foreign producers, a trade deficit acts in its full amount as a corresponding drain on domestic income and GDP.

In order to prevent this drain from dragging economic growth down, the Fed had to pursue over the years a relatively loose monetary policy. This, in fact, succeeded in generating alternative demand growth, but at the price of an ever-growing trade deficit, a most unbalanced growth pattern and escalating indebtedness.

The two apparently great similarities with past recoveries have been in surging consumer spending on durables and housing. Yet they have highly deceptive similarities. In past recoveries, this reflected a burst of pent-up demand, previously curbed by tight money. Over the past few years, the burst of such spending reflected ultra-loose monetary policy inducing people to advance future purchases. This time, it has been borrowing from the future.

The all-important point to realize is that the U.S. economy’s recovery since 2001 is completely out of whack with the strength and pattern of past recoveries. It got its growth dynamics from a steep yield curve and the housing bubble. The first one is out, and the second one is on its way out.

For policymakers and consensus economists, all this has no significance because the Greenspan Fed has developed a new highly efficient growth model — so-called asset-driven growth, in contrast to the traditional income-driven growth.

It remains a conveniently ignored fact that this new growth model, as explained earlier, has generated unprecedented indebtedness and a grossly inferior recovery.

All this raises two pivotal questions: **First*****, what is wrong with this widely hailed “asset-driven” growth model? And*** **second*****, is it at all sustainable? We are not aware of one single American economist who has posed these two utterly important questions, let alone investigated them.***

THE GREAT ECONOMIC AND FINANCIAL MISMATCH

First of all, we must emphasize that the popular juxtaposition of asset- and income-driven growth models is badly flawed. In both models, the economy is, ultimately, driven by credit.

Increasing overall spending and incomes requires credit expansion. That is the cardinal point to recognize. Sufficient volume of credit is the first consideration; direction and use of the credit is the all-important second.

Now comparing the new and the old growth models, there are tremendous differences in both respects. Under the traditional system, monetary easing directly stimulated borrowing and spending across the whole economy. Both firms and private households stepped up their borrowing and spending, supporting each other.

With this in mind, now look at the "asset-driven" model. In this case, the transmission takes place through the housing bubble. To begin with, heavy borrowing forces up the prices of houses, serving as collateral for higher borrowing. Over the four years to mid-2005, U.S. private households have increased their mortgage debt by $3,169 billion, or 66%. An unknown large part of this amount essentially went into driving up house prices, and is, of course, not available for other spending.

The important thing to see is the enormous debt intensity of this kind of economic growth. This is one catch. Another is that the resulting credit deluge pours narrowly into two sectors of the economy — housing and consumer durables, both expanding out of proportion to overall economic activity. As to housing, the credit excess actually lifts both building activity and house prices. Inexorably, both the economy and the financial system become heavily lopsided toward these sectors.

And there is a third catch with the new growth model: the unusually sluggish response of business fixed investment. In this weakest of all postwar recoveries, business fixed investment is also at its weakest, contrasting flagrantly with booming consumption. Overall nonresidential investment in the second quarter of 2005 was up 3.6% from the start of the recession in the first quarter of 2001.

Misled by their obsessive preoccupation with inflation and inflation expectations, American policymakers and economists completely fail to see that the loose monetary policies of the past few years have significantly altered the economy's whole structure. With consumption taking a growing share of GDP, capital formation and the trade balance are crowded out. There is every reason to assume that the developing major disproportions in the economy, as just described, are impairing economic growth.

How did this come about? Austrian theory gives the most compelling answer: enormous credit excess and essentially a gross mismatch in the use of this credit excess.

America has, for sure, the most powerful credit machine in the world, as Mr. Greenspan likes to boast. However, under the twofold influence of radically new thinking about successful corporate governance and Alan Greenspan's novel monetary policies, this credit machine has become exclusively geared to unproductive credit for asset shuffling, financial speculation and consumption.

The crucial distinction is between productive credit, financing investment on the economy's supply side, and unproductive credit, financing consumption and pure financial activity, like carry-trade, mergers, acquisitions and stock buybacks. Productive investment credit adds to current and future income. Consumption credit only adds to current income. Financial credit adds nothing to economic activity; it only enriches a minority.

That is why in America the rich — thanks to extensive financial leveraging — get richer and richer, while middle- and lower-income Americans — living mainly from production — get poorer and poorer.

What about the borrowing-and-spending binge of American private households? Does that not essentially create a corresponding income flow? It should, but this source of income creation is leaking heavily abroad through the huge U.S. trade deficit. While U.S. retailers gain, U.S. manufacturers and their employees lose out to foreign manufacturers.

In short, the former finely balanced relationship in the U.S. economy between consumption, saving and investment has been thoroughly destroyed through credit excesses of unprecedented scale. Similar changes have also

developed in other countries. Yet we suspect that in this respect the U.S. economy is the world's worst case of all.

Such a great mismatch in credit excess inexorably fosters a correspondingly great mismatch in the economy and its financial system. In essence, the protracted and inordinate credit excesses in the U.S. economy have stoked three major imbalances: gross overconsumption, gross underinvestment and grossly inflated asset prices.

CREDIT EXCESS RUNNING RIOT

Credit growth, financial and nonfinancial, in the United States has effectively run riot in the short time since 2000, accelerating at annual rate from about $1.6 trillion to lately close to $3 trillion. Outstanding debts totaled $37.3 trillion at the end of the second quarter of 2000.

This is 350% of national income. When Greenspan acceded in 1987, total indebtedness amounted to $8.9 trillion, or 188.9% of national income.

Looking at these atrocious debt numbers, we wonder how much of the inherent debt service is truly paid from current income and how much is just rolled over. As long as house prices rise, the lenders may readily practice the latter. Given the poor income growth, it must be playing a large and rapidly growing role. Ominously, this debt explosion is going together with an income implosion. If you think it over, it is an absurd idea to replace falling income growth with higher borrowing.

Even though consumer borrowing appears to continue unabated, consumer spending plunged dramatically in August–September in real terms. Data suggest October continued the trend. Sales of cars in October slumped further to 14.74 million units. Other data point to a significant loss of momentum in the housing sector. At 5.39%, the 1-year adjustable rate is the highest since December 2001.

Earlier, we said that Alan Greenspan reminds us of John Law. He too had the idea of "asset-driven" growth by inflating prices. But in his writings, he emphasized that sustained success is contingent upon restrained consumption. Knowing that high consumption leads to trade deficits, he wanted investment to outstrip consumption.

In the Greenspan eulogy *"Understanding the Greenspan Standard,"* presented at the Kansas City symposium, *The Greenspan Era, Lessons for the Future*, the authors, Blinder and Reis, spent not a single word in their 95 pages on the unprecedented credit excesses and the resulting enormous imbalances and disruptive changes in the growth pattern of the U.S. economy and its financial system.

It seems neat to presume politeness on their part. We conjecture more than that — general indifference and unconcern on the part of most American participants. Macroeconomic thinking appears to be completely out in America.

AN EXPORT SURPLUS HAS GREAT ATTRACTIONS

Rather, Mr. Greenspan and the consensus bulls seem to regard the runaway credit expansion in the United States as the hallmark of a grandiose, super-efficient financial system. They conveniently ignore that its stability is borrowed from the Asian central banks. If it were not for their persistent huge dollar purchases, a collapsing dollar would have shattered this system long ago.

Asian central banks are definitely not buying the dollars because they like the currency and the returns they offer. For sure, they know perfectly well that one day they will suffer huge losses on their dollar holdings. Their dollar purchases have their reason in purely domestic policy considerations, for which they are apparently willing to accept the inevitable later losses.

Preserving the international competitiveness of their producers through pegging their currency to the dollar is only one reason. A second reason is that, lagging strong enough domestic consumption, they want to push their industrialization through exports. Yet there is still a third — probably the most important — reason. A monetary reason.

With their dollar purchases, the central banks flood their domestic banks with liquidity that drives them into rapid credit expansion, financing mainly soaring investment in factories and property. By the way, this is precisely how Germany, Japan and other countries also have industrialized and prospered in the quick way.

It is, moreover, the only respectable way to liquefy a country's banking system. There is just one alternative, but an ugly one, and that is the printing press. China's sudden economic spurt has precisely coincided with the start of large dollar purchases by the central bank.

It seems that American policymakers and most economists see a sustainable mutual advantage in this U.S.-Asian dollar standard. While Asians prosper through investment, production and exports — in other words, through hard work — Americans prosper by letting the markets do the wealth creation through rising asset prices, allowing people to raise their living standards by borrowing against the gratis wealth creation.

CREDIT IS THE KEY, BUT…

We note with utter amazement and disbelief that the large fraternity of American economists, with very few exceptions, readily accepts the "asset-driven" model of economic growth as a perfectly valid alternative to the traditional "income-driven" model.

As pointed out earlier, this is a badly flawed description in the first place. Neither is the one driven by an asset, nor the other one by income. Both, actually, get their dynamics from credit expansion. The all-important factor is the increasing use of credit and the way it takes through the economy. In the Greenspan model, the use of credit is concentrated on the purchase of assets and consumption. In the traditional model of Adam Smith, it is concentrated on financing new fixed investment.

This difference in the use of credit makes all the difference between national impoverishment and growing national prosperity. Capital and wealth increase when a community produces more than it consumes. Capital and wealth decrease when the community consumes more than it produces. What is happening in the United States is, of course, the latter — with the consequence of general impoverishment.

In his lectures at the London School of Economics in 1931, which gained him his first fame among English-speaking economists, Friedrich Hayek made the distinction in the use of credit for investment or consumption his key theme.

He explained in great detail how excessive consumer spending brings about *"a shortening or shrinkage of the process of production,"* and so causes recession. What shrinks is the economy's capital base. In essence, production that uses capital increasingly gives way to production using little or no capital.

In other words, the whole economy adjusts to the changes in the pattern of demand implemented by the credit excess. Look at the monthly reports in the United States about the changes in employment, and you see this debilitating process in rapid progress. Employment in capital-intensive manufacturing has plummeted, while employment in all kinds of low-paying services has soared.

Pointing out the tremendous difference in the structural effects of consumption-driven and investment-driven economic growth, we must further draw attention to a tremendous change in the relationship between debt and GDP growth in the United States.

For decades until the late 1970s, one dollar added to GDP in the United States was tied to $1.40 in additional debt. This relationship has continuously worsened. The Greenspan growth model has driven it to a record high. For one dollar of additional GDP, lately, there are $4 in additional debt.

It is generally not realized that all unproductive debt rapidly compounds. Every new spending requires ever-new credit, and in addition, there runs the soaring bill of compounding interest.

Now compare this with a credit expansion for investment purposes. The debts run up as long as the capital goods are produced. Once these are installed, earned depreciations pay them off. As a rule, though, the depreciations serve, in turn, to finance a virtually endless flow of reinvestments.

THE WONDERS OF A STEEP YIELD CURVE…

We come to another crucial feature of the Greenspan growth model. It is the protracted existence of a steep yield curve as an incentive for financial leveraging by borrowing at low short rates and lending at high long rates. Such yield curves have existed before in times of economic weakness, but the Greenspan Fed is the first central bank to have made systematic and aggressive use of a steep yield curve to boost asset prices for financial and economic purposes.

There is much talk today about the housing bubble, but to have it, it first needed the bond bubble to provide the low long-term rates as an incentive for the mortgage refinancing bubble.

Persistent public declarations on the part of Fed speakers to keep short-term rates at their rock-bottom level for a prolonged period served to induce carry trade of many trillions of dollars.

In this way, the artificially low short-term rates led to artificially low long-term rates leading, in turn, to a generally gross overvaluation of assets. The striking desired result was America's greatest consumer borrowing and spending binge. Credit exploded while savings imploded. Nothing like this has ever happened before.

What made this extraordinary development possible is America's system of extremely versatile and highly leveraged financial institutions and their ability to fund virtually limitless lending either directly through the money and repo markets or through securitization.

These most aggressive lending institutions do not belong to the banking system. Their official title is "nonbank financial intermediaries." Yet like banks, they create credit and thus finance the spending of ultimate borrowers; and like banks, they keep liquid reserves. But their reserve assets and their means of payment are deposits at commercial banks, in contrast to reserve assets, which commercial banks hold at the central bank.

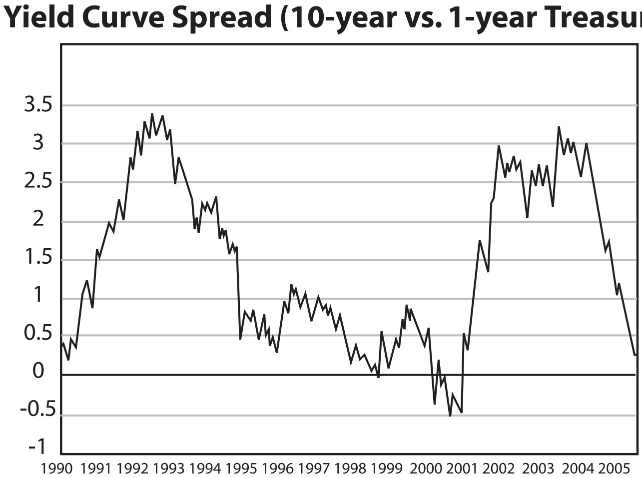
These institutions are a specialty of the Anglo-Saxon financial systems. In essence, they vastly increase the financial system's capacity of credit creation. That is one big problem. The other one is that their lending activity is restricted to consumer credit and the carry trade of financial assets. Their existence is probably a main reason for the strong propensity of Anglo-Saxon countries for consumption and leveraged financial investment.

In the past, the growth of these institutions was very limited, depending on soliciting for individual deposits. But with securitization at their disposal in a world of loose money and a steep yield curve, they could virtually print loans and liabilities at will. And they did.

…HAVE A VERY DANGEROUS LEGACY

The key condition for all this, however, is a positive yield curve, and this is presently at stake. What the Fed apparently wanted with its rate hikes was a compatible rise in the long-term rate to restrain mortgage equity withdrawals and consumer spending. Implicitly, this would also have sustained the positive yield curve rather longer. The problem is that the resistant long-term bond yields have led to an early flattening of the yield curve, now threatening its imminent inversion.

Yield Curve Spread (10-year vs. 1-year Treasury)



Source: U.S. Treasury

This will quickly put those highly leveraged and thinly capitalized nonbank financial intermediaries into a very precarious position. There are, actually, two problems to envision. One is the further financing of the huge carry-trade bubble in bonds. If this bubble bursts under the impact of an inverted yield curve, a fire sale of unimaginable scale will shatter the U.S. bond market. The other problem is the financing of the current credit

expansion, recently running at an annual rate close to $3 trillion.

It is not the first time, of course, that the Fed or any other central bank has imposed an inverted yield curve. Just think of Paul Volcker's onslaught in 1979. Yet the system generally survived without deep wounds.

But this time, it is different. The crucial difference between past and present resides in today's high dependence of the whole financial system on carry trade for bonds, requiring permanent new financing to avoid a steep rise in U.S. long-term rates.

There is an ominous precedent in this respect: soaring U.S. long-term rates in 1994 after a prolonged period of a steep yield curve. Starting in 1989, the Fed slashed its funds rate over four years from 10% to a low of 3%. With annualized real GDP growth in late 1993 in excess of 6%, it acted to forestall inflation. In six subsequent steps, it raised its funds rate by altogether 2.5 percentage points, to 5.5%.

To everybody's surprise, long-term rates responded with unprecedented vigor. The yield on 30-year U.S. government bonds shot up from 5.78% in October 1993 to 8.16% in early November 1994, ending the year at 7.89%.

With the benefit of hindsight, the cause of this unprecedented behavior of long-term bonds seems obvious. Over the long period of a steep yield curve, a big carry-trade bubble had accumulated in long-term bonds. When the Fed hiked its rate, the holders promptly unloaded, driving long-term rates steeply up.

There is no question that today's carry trade bubble in U.S. bonds is many times bigger. Exploding financial credit over the past several years appears strongly indicative. But in contrast to 1994, the carry-trade community sticks to its highly leveraged positions.

This raises our curiosity about two things: *first*, reflections behind this tenacity; and *second*, future implications. The familiar "Greenspan put" may play a great role; that is, the ingrained view that if things go wrong, the Fed will radically ease and restore positive conditions for carry trade.

By conventional measures, comparing present interest rates with the high inflation rates, U.S. monetary policy still appears highly "accommodative," to use the Fed's parlance. But what matters for the financial system is the yield curve, and that is on the verge of inverting.

If the yield curve inverts and investors capitulate, both the U.S. economy and U.S. markets are sure to crash, because both crucially depend on a functioning carry-trade bubble in bonds through a positive yield curve. We wonder whether the Fed sees this problem.

THIS IS STRUCTURAL, NOT CYCLICAL

The hot question at the moment is whether the U.S. economy is in a definite, sharp slowdown or in another soft patch. Even notorious bulls admit to some surprising weakness in recent data. But do not worry, they argue, for these are temporary effects from the surge in energy prices and the hurricanes, to be followed by even stronger growth owing to the necessary rebuilding.

The first thing to realize, in our view, is that the U.S. economy has suffered a major structural break in the past several years. It shows most strikingly in three features: *first*, the dramatic shortfall of employment and labor income growth; *second*, the ballooning trade deficit; and *third*, the explosion of credit and debt.

What has prevented a deepening recession has been the willingness of private households to supplement their slumping income growth with a borrowing stampede. In other words, they readily took the bait of rising house prices and ultra-cheap credit. It has worked for about three or four years. Nevertheless, it was always clear that this growth model could not last.

The new fact to see is that consumer income growth over the last four to five months has dramatically deteriorated again. Thanks to heavy borrowing, spending has held up better, but at the expense of saving. Disposable personal income (in chained dollars) in September was no higher than in May. Its counterpart are the worst savings numbers: negative $158 billion in the first quarter '05, negative $40 billion in the second and negative $107.5 billion in the third.

During the third quarter, consumer spending (in chained dollars) in August fell by $76 billion and in September by $33.4 billion. Meanwhile, we know that retail sales in October fell slightly, but minus auto sales, rose less than the inflation rate.

The key consideration for us is that the minimal improvement in employment and wage growth during 2003–04 is rapidly vanishing again. To save the recovery, it would need sharply accelerating job and income growth. Just the opposite, though, is happening. For the three months ended October, reported payroll employment expanded 196,000, against a rise by 600,000 a year ago. The weak numbers, by the way, have been coming from the whole of the economy.

A BOGUS RECOVERY

All of this leaves us with the vital question of what has been causing this employment disaster in the U.S. economy, with the further question in mind whether these causes are temporary or of lasting nature.

For sure, the soaring trade deficit has been a big job killer. An import surplus means that domestic spending is diverted to this extent away from domestic producers to foreign producers. With a deficit of now around $800 billion per year, this has big negative job and income effects in U.S. manufacturing.

But given real GDP growth of 4.2% in 2004 and of 3.5% so far in 2005, it is manifest that this loss of spending and income on account of the trade deficit was offset by higher alternative spending created by loose fiscal and monetary policy. Manufacturing lost, while services gained. This is part of the U.S. economy's restructuring process.

In actual fact, there has been a dramatic break in the U.S. economy's pattern of growth. During 1995–2000, business fixed investment had accounted for 26% of real GDP growth. In the five years to 2005, it has been close to zero. Personal consumption increased its share of GDP growth between the two periods from 73% to 81%. If this explains anything, it would be a collapse of productivity growth, but it does not explain the employment disaster. Services are labor intensive.

The fact is that there are enormous inconsistencies in U.S. economic statistics. Thinking all possibilities through, we see only one reasonable explanation for the U.S. employment disaster. For well-known reasons, grossly understated inflation rates bring about a commensurate gross overstatement of GDP, productivity and income growth.

The convenient bullish explanation is the productivity miracle. For sure, there is a miracle, but only in the statistics, not in the economy. Productivity growth by itself does not add one single dollar to GDP. Only spending does, and that is by no means implicit to productivity growth.

It is to our greatest amazement, therefore, that in its press releases to the rate hikes the FOMC stereotypically repeats the remark that *"robust underlying growth in productivity is providing ongoing support to economic activity."* If this is their true opinion, it is frightening, because it is bogus economics.

EVERY BUBBLE HAS AN AFTERMATH

To escape the aftermath of the equity bubble, the Fed created the housing and bond bubbles in 2001 and the following years. It is time, we think, to ponder the aftermath of these two asset and credit bubbles. The inverting yield curve is primarily threatening the huge existing carry-trade bubble in bonds. But the big housing bubble and the smaller car bubble too have plainly peaked. Rising interest rates and poor income growth are relentlessly taking their toll.

It should be immediately clear that the potential economic and financial aftermath of a bust of these bubbles will be many times worse than the potential aftermath of the earlier equity bubble. Spending and debt excesses have multiplied over the past four to five years to an extent that threatens the stability of the whole U.S. financial system.

Lately, Mr. Greenspan's public speeches have insinuated that the high asset prices in the United States in

recent years may, ironically, be due to the extraordinary success of his policies, by leading investors to demand lower risk premiums. Eventually, however, this reverses and asset prices fall reflecting *"the all-too-evident alternation and infectious bouts of human euphoria and distress and the instability they engender."*

Yet he emphasized that it is "simply not realistic" to expect the Fed to identify and safely deflate asset bubbles. The right response in his view is for all policymakers to keep markets as flexible and unregulated as possible. Flexible markets, he said, helped absorb recent shocks, such as stock-bubble collapse and the Sept. 11, 2001, terrorist attack.

We are not sure what shocked us more, this senseless, arrogant remark or the complete silence on the part of American economists. Exuberance, just by itself, is unable to inflate asset price levels. The indispensable primary condition is always credit excess, and Mr. Greenspan delivered that in unprecedented profligacy. By the nature of things, loose money and credit excess lead, and exuberance follows.

CONCLUSIONS:

America's reported economic recovery since 2001 has been its weakest by far in the whole postwar period. For the working population, there never was a recovery. They speak euphemistically of a shortfall of employment and income growth. It is better described as a fiasco for both.

Two acute dangers presently lurk in the U.S. economy and its financial system. One is the inverting yield curve threatening to pull the rug out from under the huge carry-trade bubble in bonds, and thereby from under the housing bubble. The other is the slump in consumer spending. Consumer borrowing is slowing, while employment and labor income growth are weakening again.

It seems that the carry-trade community is betting on prompt rate cuts by the Fed if something goes wrong in the economy or the financial system. We suspect that the Fed, grossly underestimating the enormous vulnerabilities in both sectors, will stick to its rate hikes. The interest "conundrum" is pretty much the only thing holding up this house of cards.

"Super-liquid markets" has become the common bullish catchphrase. It should be realized, however, that the existing liquidity deluge in the United States and some other countries has its sole source in the monstrous asset bubbles providing the collateral for virtually limitless borrowing. It needs a sharp distinction between earned liquidity from saving and borrowed liquidity accrued from asset bubbles. The latter kind of liquidity can vanish overnight.

The sharp surge in inflation rates is forcing the Fed to continual rate hikes. Doing so, it takes enormous risks with the existing bubbles. Bluntly put, it has lost control.

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